INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes and regulations involved	2
Statement	2
Argument	4
Conclusion	9
Appendix	10

CITATIONS

Cases:

Bank of Newberry v. *Commissioner*, 1 T. C. 374	8
Burnet v. *Sanford & Brooks Co.*, 282 U. S. 359	8, 9
Burroughs Adding Machine Co. v. *Commissioner*, 9 B.T.A. 938	7
Central Hanover Bank & Trust Co. v. *Commissioner*, 159 F. 2d 865	8
De Loss v. *Commissioner*, 28 F. 2d 803, certiorari denied, 279 U. S. 840	9
Dobson v. *Commissioner*, 320 U. S. 489	7, 8
Douglas v. *Commissioner*, 322 U. S. 275	9
Lucas v. *Structural Steel Co.*, 281 U. S. 264	7
New Colonial Co. v. *Helvering*, 292 U. S. 435	9
Virginian Hotel Co. v. *Helvering*, 319 U. S. 523	8

Statutes:

Internal Revenue Code:

Sec. 22 (26 U.S.C. 1946 ed., Sec. 22)	5, 6, 10
Sec. 113 (26 U.S.C. 1946 ed., Sec. 113)	11

Revenue Act of 1932, c. 209, 47 Stat. 169:

Sec. 23	12
Sec. 113	12

Revenue Act of 1936, c. 690, 49 Stat. 1648:

Sec. 23	12
Sec. 113	12

Miscellaneous:

Kester, *Principles of Accounting* (Third Rev. ed., 1930), p. 50	5

Treasury Regulations 103:

Sec. 19.22(a)-5	5, 12
Sec. 19.22(b)(12)-1	13
Sec. 19.22(c)-1	14
Sec. 19.22(c)-2	14
Sec. 19.22(c)-5	5, 15
Sec. 19.23(k)-1	16

In the Supreme Court of the United States

OCTOBER TERM, 1948

No. 794

THE UNION TRUST COMPANY OF INDIANAPOLIS,
PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The District Court did not write an opinion. Its findings of fact and conclusions of law (R. 31-41) are not officially reported. The opinion of the Court of Appeals (R. 57-61) is reported at 173 F. 2d 54.

JURISDICTION

The judgment of the Court of Appeals was entered on March 2, 1949. (R. 62.) The petition for a writ of certiorari was filed on May 16, 1949. The

jurisdiction of this Court is invoked pursuant to 28 U.S.C., Sec. 1254.

QUESTION PRESENTED

Taxpayer bank, in its capacity as a dealer in securities, kept its books on the inventory basis of accounting. During 1932, 1933 and 1937, loss years, taxpayer wrote down the inventory value of certain securities without any resulting tax benefit. Is taxpayer entitled under Section 22(b)(12) of the Internal Revenue Code to exclude from taxable income recoveries of such write-downs realized in 1939? The answer depends upon whether or not the adjustment of inventory values of securities constitutes a charge-off of "bad debts" arising from "worthlessness or partial worthlessness" of the securities.

STATUTES AND REGULATIONS INVOLVED

These are set out in the Appendix, *infra*, pp. 10-17.

STATEMENT

The facts, as stipulated and found by the District Court (R. 31-40), may be summarized as follows:

The taxpayer is a bank located in Indianapolis, Indiana. As part of its functions during the period in question, taxpayer operated a bond department through which it bought corporate and governmental bonds for the purpose of resale to customers. (R. 32.) Beginning with the taxable year 1921 and up to and including the taxable year 1939, taxpayer with the approval of the Commissioner of Internal Revenue filed its income tax returns with

respect to these securities on the inventory basis. (R. 32.) The inventory was valued at the end of each year at cost or market, whichever was lower. Once the value of a given security was reduced on the inventory set out in the income tax return, the reduced value was thereafter treated as cost. (R. 32-33.) These inventories set out in the tax returns were used in computing the cost of gross sales and gross profits from the sales of securities, but taxpayer during the period in question also kept a security ledger in which it recorded the purchase date, description and the purchase price of each individual security. (R. 33.)

Exhibit 2 to the stipulation of facts (R. 37) lists certain issues of bonds which were part of taxpayer's inventory for income tax purposes. These bonds were acquired prior to 1939 and were sold or redeemed during 1939 at a profit over their inventory value. (R. 34, 37.) In the years 1932, 1933 and 1937 the taxpayer incurred substantial losses which were recorded in its income tax returns. (R. 35.) During these three years the values of certain of the Exhibit 2 bonds were reduced. (R. 37.) The losses incurred by taxpayer during the years in question exceeded its gross inventory reductions or write-downs, and even without the inventory reductions, taxpayer would have incurred no income tax during these years. (R. 35, 37, 40.) In 1939 when it redeemed or sold the bonds listed in Exhibit 2 the amount received therefrom was $34,055.76 more than the latest previous inventory valuation.

(R. 37.) Of this amount $22,335.76 arose from inventory reductions in taxpayer's loss years. Taxpayer claims that the amount of $22,335.76 is excludable from income subject to tax. (R. 37.)

Taxpayer's total payments for 1939 income tax amounted to $21,946.70 plus interest. (R. 33.) By claim for refund filed February 17, 1943, taxpayer claimed $4,454.31 as an overpayment of 1939 on the ground that (R. 7, 13, 33-34):

> Recoveries on bad debts and bonds which were charged off in a tax loss year were included as income and a tax paid thereon.

The Commissioner of Internal Revenue rejected the claim to the extent of $3,730.14. (R. 3, 13, 34.) Thereafter the taxpayer brought this action. (R. 1.)

The District Court found and concluded (R. 39-41) that the reductions in inventory value of the bonds in question were bad debts and that the amounts received for the bonds in 1939, to the extent of inventory reductions in loss years, did not constitute taxable income. Judgment was accordingly entered for the taxpayer in the principal amount of $3,730.14, together with interest and costs. (R. 41.) The Government appealed to the Court of Appeals for the Seventh Circuit which reversed the judgment and ordered that the petition be dismissed. (R. 61-62.)

ARGUMENT

It is clear from the record that the taxpayer purchased and held the securities in question for re-

sale to customers at a profit, rather than for investment. (R. 32.) Hence, for present purposes, it is a merchant of securities. Treasury Regulations 103, Section 19.22(c)-5, Appendix, *infra*. As such, its gross income for tax purposes was properly determined on the inventory basis as the difference between gross sales and the cost of goods sold[1] without "subtractions . . . for depreciation, depletion, selling expenses, or losses, or for items not ordinarily used in computing the cost of goods sold." Treasury Regulations 103, Section 19.22 (a)-5, Appendix, *infra*.

The taxpayer's petition is, however, predicated mainly on the assumption that there is no distinction between its operations as a dealer in securities, in which it properly employed the inventory method of accounting, and its ordinary operations as a bank, in the course of which it was allowed bad-debt deductions arising from the worthlessness or partial worthlessness of promissory notes and other obligations. What the taxpayer is now attempting to do is to bring the transactions in question within the scope of Section 22(b)(12) of the Internal Revenue Code, which provides for the exclusion from income of recoveries in respect of bad debts and certain other items that have been deducted in prior years without tax benefit therefrom.

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[1] The taxpayer's opening inventory, plus the cost of inventoriable items purchased during the year, less the value of the closing inventory, determines the cost of goods sold during the taxable year. See Kester, *Principles of Accounting* (Third Rev. ed., 1930), p. 50.

To achieve this purpose, it seeks to treat the write-downs, under the inventory method of accounting which it had adopted and to which the Commissioner had acceded, of bonds which it acquired for sale to its customers as a writing off of "bad debts." Aside from the fact that the taxpayer itself did not treat these write-downs as bad debts in its returns for the loss years in question, it is plain that they are not "bad debts", within the scope either of Section 22(b)(12) or of any other reasonable definition of that term. Section 22(b)(12)(A) (Appendix, *infra*) defines a "bad debt" as a "debt on account of worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year." Examination of Exhibit 2 (R. 37) shows that over 40% of the bonds which the taxpayer wrote down for inventory purposes were United States Treasury Bonds, which could not possibly be regarded as worthless or even partially worthless. (R. 60.) Similarly, certain of the bonds in question (e.g., Item 16, Ex. 2, R. 37) were purchased at a premium, which premium was written off in 1937 and partially recovered in 1939. The amount of the debt was at all times the same, and it is obvious that the taxpayer could not in 1937 have deducted the amount of the premium as a "bad debt", even had it attempted to do so.

The foregoing considerations stress the impracticability of attempting to treat the bonds which the petitioner bought and sold in the course of its business as a merchant of securities in the same

manner as notes which it acquired in the course of its regular banking business and which became worthless or partially so because of the insolvency of the debtor.[2] As the Court of Appeals pointed out, the bonds in question, under the system of accounting which the petitioner adopted for tax purposes and which was appropriate to its business, "lost their individual identity in the general inventory." (R. 60.) Under the inventory method, in other words, the bonds in question have lost their character as debts and, for present purposes, are considered as so much merchandise for sale to customers. The taxpayer's effort to itemize and trace them through prior years is no more appropriate than it would be in the case of drygoods or hardware. Cf. *Lucas* v. *Structural Steel Company,* 281 U. S. 264, 269; *Burroughs Adding Machine Co.* v. *Commissioner,* 9 B.T.A. 938, 943.

The taxpayer relies chiefly upon *Dobson* v. *Commissioner,* 320 U. S. 489, which the court below considered carefully and found inapplicable. (R. 61.) The taxpayer in that case was not a dealer in securities, and there was presented no question of departure from a long established method of accounting for tax purposes. The *Dobson* case is certainly not authority for the proposition that Section 22(b)(12) is intended to authorize departure from the basic principle that income

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[2] The taxpayer's claim for refund was allowed to the extent that it was predicated upon recoveries of loans on promissory notes previously charged off without tax benefit. (R. 3, 13, 34.)

taxes are imposed and must be accounted for on a yearly basis. *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359. In the *Dobson* case this Court upheld the finding of the Tax Court that, viewing as a whole the transactions out of which the recovery there in question arose, the taxpayer had realized no taxable income; but that case presented no such situation as is here concerned, where the taxpayer was a dealer in securities and used the inventory method of accounting. *Central Hanover Bank & Trust Co.* v. *Commissioner*, 159 F. 2d 865 (C. A. 2), asserted by the petitioner to be in conflict with the instant case, is equally inapplicable, for in that case the taxpayer had actually taken the bad debt deductions in earlier years, and there was no question of revaluing inventories. *Bank of Newberry* v. *Commissioner*, 1 T. C. 374 (Acquiescence, 1943 Cum. Bull. 2), also cited by the taxpayer, is inapplicable for similar reasons. A much more pertinent analogy is *Virginian Hotel Co.* v. *Helvering*, 319 U. S. 523, rehearing denied, 320 U. S. 810, where the taxpayer contended that excessive depreciation taken in prior loss years should be restored to cost basis, insofar as the depreciation had not resulted in tax benefit, for the purpose of computing current deductions. This Court held that the depreciation deduction is not a "guarantee" that investment will be recovered tax-free, and that Congress had not "indicated that a taxpayer who has obtained no tax advantage from a depreciation deduction should be allowed to take it a second time." 319 U. S. at

528. Cf. *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359; *New Colonial Co.* v. *Helvering*, 292 U. S. 435; *Douglas* v. *Commissioner*, 322 U. S. 275. The position of the taxpayer in the instant case amounts to an assertion that write-downs because of fluctuations in value of merchandise may be treated as bad debts for tax purposes, and we do not understand such to be the law. Cf. *De Loss* v. *Commissioner*, 28 F. 2d 803 (C.A. 2), certiorari denied, 279 U. S. 840.

CONCLUSION

The decision of the Court of Appeals is correct, there is no conflict, and the petition should be denied.

Respectfully submitted,

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JUNE, 1949.

APPENDIX

Internal Revenue Code:

SEC. 22. GROSS INCOME.

* * * * *

(b) *Exclusions from Gross Income.*—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

* * * * *

(12) [as added by Sec. 116 of the Revenue Act of 1942, c. 619, 56 Stat. 798].[3] *Recovery of Bad Debts, Prior Taxes, and Delinquency Amounts.* Income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount. For the purpose of this paragraph:

(A) *Definition of Bad Debt.*—The term "bad debt" means a debt on account of worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

* * * * *

(D) *Definition of Recovery Exclusion.*—The term "recovery exclusion," with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Commissioner with the

[3] Subsection (c) of Section 116 makes these additions effective as if a part of the Revenue Act of 1938 and prior Revenue Acts.

approval of the Secretary, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax under this chapter (not including the tax under section 102) or corresponding provisions of prior revenue laws, reduced by the amount excludible in previous taxable years with respect to such debt, tax, or amount under this paragraph.

* * * * *

(c) *Inventories.*—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

(26 U.S.C. 1946 ed., Sec. 22.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

(1) *Inventory Value.*—If the property should have been included in the last inventory, the basis shall be the last inventory value thereof:

(26 U.S.C. 1946 ed., Sec. 113.)

Section 113(a)(1) of the Revenue Act of 1932, c. 209, 47 Stat. 169, and Section 113(a)(1) of the Revenue Act of 1936, c. 690, 49 Stat. 1648, contain identical words.

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(j) *Bad Debts.*—Debts ascertained to be worthless and charged off within the taxable year * * * and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

* * * * *

Section 23(k) of the Revenue Act of 1936, c. 690, 49 Stat. 1648, contains identical words.

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.22(a)-5. *Gross income from business.*—In the case of a manufacturing, merchandising, or mining business, "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. In determining the gross income subtractions should not be made for depreciation, depletion, selling expenses, or losses, or for

items not ordinarily used in computing the cost of goods sold. * * *

SEC. 19.22(b)(12)-1 [as added by T. D. 5288, 1943 Cum. Bull. 103, and amended by T. D. 5454, 1945 Cum. Bull. 68]. *Recovery of certain items previously deducted.*—(a) *In general.* Section 22(b)(12) provides that income attributable to the recovery during any taxable year of bad debts, prior taxes, and delinquency amounts shall be excluded from gross income to the extent of the "recovery exclusion" with respect to such items. The rule of exclusion so prescribed by statute applies equally with respect to all other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years, including war losses referred to in section 127, but not including deductions with respect to depreciation, depletion, amortization, or amortizable bond premiums. (See *Dobson* v. *Commissioner,* 64 S. Ct. 239.) The term "recovery exclusion" as used in these regulations means accordingly an amount equal to the portion of the bad debts, prior taxes, and delinquency amounts (the items specifically referred to in section 22(b)(12)), and of all other items subject to the rule of exclusion which, when deducted or credited for a prior taxable year, did not result in a reduction of any tax of the taxpayer under Chapter 1 of the Internal Revenue Code (other than a tax under section 102) or under corresponding provisions of prior revenue laws.

(1) *Section 22(b)(12) items.*—The term "section 22(b)(12) items" as used in these

regulations means those bad debts, prior taxes, delinquency amounts, and all other items subject to the rule of exclusion, for which a deduction or credit was allowed for a prior taxable year. If a bad debt was previously charged against a reserve by a taxpayer on the reserve method of treating bad debts, it was not deducted, and it is therefore not considered a section 22(b)(12) item. * * *

(2) *Definition of "recovery."*—Recoveries result from the receipt of amounts in respect of the previously deducted or credited section 22(b)(12) items, such as from the collection or sale of a bad debt, refund or credit of taxes paid, or cancellation of taxes accrued. * * *

* * * * *

SEC. 19.22(c)-1. *Need of inventories.*—In order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. * * *

SEC. 19.22(c)-2. *Valuation of inventories.*—Section 22(c) provides two tests to which each inventory must conform:

(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and

(2) It must clearly reflect the income.

It follows, therefore, that inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the

best accounting practice in the particular trade or business. In order clearly to reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is substantially in accord with these regulations. An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income. * * *

* * * * * *

SEC. 19.22(c)-5. *Inventories by dealers in securities.*—A dealer in securities who in his books of account regularly inventories unsold securities on hand either—

(a) At cost;

(b) At cost or market, whichever is lower; or

(c) At market value,

may make his return upon the basis upon which his accounts are kept; provided that a description of the method employed shall be included in or attached to the return, that all the securities must be inventoried by the same method, and that such method must be adhered to in subsequent years, unless another method be authorized by the Commissioner pursuant to a written application therefor filed with the Commissioner as provided in section 19.41-2. A dealer in securities in whose books of account

separate computations of the gain or loss from the sale of the various lots of securities sold are made on the basis of the cost of each lot shall be regarded, for the purposes of this section, as regularly inventorying his securities at cost. For the purpose of this rule a dealer in securities is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. If such business is simply a branch of the activities carried on by such person, the securities inventoried as here provided may include only those held for purposes of resale and not for investment. Taxpayers who buy and sell or hold securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business, and officers of corporations and members of partnerships who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this rule.

SEC. 19.23(k)-1. *Bad debts.*

* * * * *

(b) If all the surrounding and attending circumstances indicate that a debt is worthless, either wholly or in part, the amount which is worthless and charged off or written down to a nominal amount on the books of the taxpayer shall be allowed as a deduction in computing

net income. There should accompany the return a statement showing the propriety of any deduction claimed for bad debts. * * * Before a taxpayer may charge off and deduct a debt in part, he must ascertain and be able to demonstrate, with a reasonable degree of certainty, the amount thereof which is uncollectible. Any amount subsequently received on account of a bad debt or on account of a part of such debt previously charged off and allowed as a deduction for income tax purposes, must be included in gross income for the taxable year in which received. In determining whether a debt is worthless in whole or in part the Commissioner will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor. * * *

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